Dollarization is the Second Best Option for Small Open Economies

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Highlights…. a work in progress

- This paper will argue that small open economies benefit from having their own currencies only if they succeed in anchoring to a reserve currency at an exchange rate which never varies.

- The main benefit to the issuing country is the credibility that government derives from the implementation of policies that sustain the exchange rate with a major reference currency. Should the exchange rate be devalued for any reason, that credibility is lost, and an own currency becomes a considerable liability, creating uncertainty and distorting choices in government and the private sector.
- In this circumstance, full dollarisation becomes the preferred option, removing the uncertainty about the value of domestic assets, and the associated incentive for capital flight.

Advantages of having one's own currency

- **Strengthens credibility of fiscal policy by securing popular buy-in for difficult fiscal choices**- the only worthwhile benefit that small open economies derive from having their own currency.
- In Barbados in 1991 and in Latvia in 2011, the authorities were able to push through draconian fiscal adjustment measures thanks to the national consensus on maintaining the value of the domestic currency
- In contrast, countries that attempted similar adjustment with a mix of fiscal, monetary and exchange rate policies typically experienced crises which set back development eg. **Jamaica** from the late 1970s and **Indonesia** in 1997.
- Countries like **Greece and Cyprus** that are members of a currency union have fared no better, because capital markets failed to impose discipline on fiscal spending (actual and contingent) in a timely manner. Correction turned out to be a protracted affair, with adverse effects on long term development.
- In contrast the fiscal adjustments in **Barbados and Latvia** were short term, with no noticeable long term effects on development.

Latvia strong reforms for EU accession

- A year after completing a difficult adjustment program, Latvia is the fastest growing economy in the EU.
- Despite the recession in the euro area, Latvia's GDP growth is projected to have exceeded 5 percent for the second year in a row in 2012. But unemployment high but fell from 16% to 13%.
- With its strong recovery, Latvia repaid last Dec the o/s amount of its IMF loan ahead of the 2015 schedule.
- Latvia's budget deficit is set to narrow to 1.4 percent of GDP in 2013 from about 9.8 percent in 2009. Inflation 1.7%

Other Alleged Own Currency Benefits: Seignorage

- In their balanced and comprehensive review of the pros and cons of full dollarisation, Jacome and Lonnberg (2010) cite **four other benefits of having an own currency.** The most often cited is **seignorage,** the difference between the face value of the currency and the cost of producing it. To maximize the benefit from seignorage, it should really be invested in the creation of additional productive capacity to accelerate the growth of the economy.
- Unfortunately, small economies are obliged to back their currency issue by an equal or greater amount of foreign reserves, so the seignorage is reduced to the interest earnings on foreign exchange holdings, a trivial percent of GDP.
- Anthony and Hughes Hallett (1999) argue that seignorage revenues <u>in the Caribbean are less than the transactions cost of currency exchange</u>, so <u>there is a net cost to having an own currency</u>.

Other Alleged Own Currency Benefits: Devaluation shock absorber

- Secondly, economists who do not understand small open economies argue that an own currency may be devalued to reduce the impact of a fall in foreign exchange earnings or an oil price increase (the so-called "shock absorber" effect).
- That may well be the case for large diversified economies with significant potential for import substitution, but it is not possible in the small open economy. In a large economy with a diversified production structure, when a devaluation raises the prices of imports, domestic consumers have an incentive to switch to local substitutes, and this stimulates domestic production.
- Small economies have a limited range of domestic commodities that may be supplied at internationally competitive prices. So devaluation tends to contract income

Other Alleged Own Currency Benefits: lender of last resort

- Thirdly, it is argued that having your own currency means the central bank has no limit on its ability to act as lender of last resort to financial institutions short of liquidity, while with dollarisation the central bank cannot create money and act as lender of last resort.
- However, if the liquidity shortage is as a result of a flight to a safer domestic bank, there is a circular flow of funds through the central bank, as the receiving bank's reserve accounts with the central bank increase. Thus it does not matter whether there is an own currency
- If the liquidity shortage a financial institution experiences is as a result of capital flight, in a country with its own currency, Central bank money creation to supply liquidity will aggravate the foreign exchange loss resulting from the capital flight, and the foreign exchange constraint will kick in to limit the central bank accommodation.
- Finally, dollarized countries typically create a reserve fund of foreign exchange to finance the lender of last resort scenarios.

Other Alleged Own Currency Benefits: inflation benefits

- Fourthly, Jacome and Lonnberg cite the fact that inflation resulting from a devaluation reduces the real burden of domestic debt as an argument for having an own currency, but that seems a cure that is worse than the disease. Inflating the economy at a high rate is the fastest way to reduce the ratio of debt to GDP, but it erodes the value of domestic savings and increases incentives for capital flight. Rather than being considered a benefit, this is a powerful argument against an own currency.

Dollarization Benefits

- Jacome and Lonnberg also cite the benefits of full dollarisation:
- the convergence of domestic to world inflation,
- lower interest rates because of elimination of currency risk, and a better investment climate as a result.
- long term borrowing for countries where long term funding has dried up because of a history of persistent inflation.
- What is striking about this list, is that a country with its own currency benefits from each one of these items, so long as it maintains an unchanged peg with a reference currency. the rate of inflation will converge to the inflation rate of the reserve currency country, interest rates will be comparable (apart from a country risk premium), investors will perceive no currency risk, and long term obligations in domestic currency will be widely accepted. These benefits accrue only if the exchange value of the domestic currency is sustained through intervention in the exchange market by a central bank which maintains adequate reserves of foreign exchange for this purpose.

Main Own Currency Advantage Relative to Dollarization

- The use of fiscal policy to manage aggregate demand and the resulting demand for imports is the most effective way to ensure a balance of external payments, and therefore to avoid an erosion of foreign exchange reserves.
- In the event that the exchange rate has to be shifted, for whatever reason, there is no merit to having an own currency in a small open economy, and full dollarisation becomes the preferred option. The country loses a powerful fiscal tool, but retains the benefits of low inflation, low interest rates, a favourable investment climate and the full range of maturities in capital markets. Full dollarisation is to be recommended for all small open economies whose currencies have been devalued. These countries will have lost a fiscal policy tool, but they will retain all the other benefits, with no disadvantages.

The exchange rate anchor lends credibility to fiscal policy

- The only instrument available to policy maker in small open economies for balancing the external accounts is fiscal management of aggregate demand. The import content of aggregate spending in SOEs is very high, typically over 70%, and a reduction of aggregate demand will have a powerful effect on external demand. Government may contain aggregate spending through a suitably large reduction in the fiscal deficit, and in addition it may further affect the external balance depending on how the deficit is financed. If it is possible to finance a larger portion of the deficit from external sources at affordable rates, the resulting capital inflow will assist in achieving external balance with somewhat milder contraction in aggregate spending. Conversely, if any portion of the deficit is financed by money creation by the central bank, the resulting wealth effects on aggregate spending will worsen the external imbalance.

How to Dollarize
(Why the risks tend to be low)

1. **Building Credibility**

- Communicating a clear understanding of the rationale
  - Lower inflation, lower interest rates, greater fiscal discipline
- Decisive action by authorities
  - New legislation may be necesary to define the new role of the Central Bank
- Realistic assessment of the risks
- Consideration of appropriate safeguards

How to Dollarise

2. Realistic Assessment of Risks of Dollarisation

- Consider uniqueness of the country circumstances. We are examining several country case studies but only a few are summarized here

- **Zimbabwe dollarized in a context of chronic macro-economic instability** typified by hyperinflation and allegations of political instability. They introduced a new variation where **any foreign currency is accepted as legal tender,**
- Did not withdraw the local currency.
- Yet, the new arrangements quickly stabilized inflation.

- **Ecuador in 2000 dollarized during a financial crisis to stabilize the economy during a period of significant currency depreciation of the flexible exchnge rate.**
- In 1988 with a ballooning fiscal deficit of 6.2 % the government cut subsidies, raised gasoline prices, hiked interest rates and devalued the exchanged rate band by 15%. But more needed to be done to stabilize the economy.
- **Period of relatively weak political credibility, from 1997; there was a general strike and three separate individuals claimed to be President of Ecuador.**
- Minister of Finance & Governor of Central Bank resigned in 1999.
- Deep debt crisis and they later defaulted on debt payments.

Ecuador continued

- IMF former First Deputy Managing Director indicates that

“There is much food for thought in the story of Ecuadorian dollarization-not least, that the early success of what was a desperation move, taken in haste,

<u>“without most of the necessary preconditions being in place,</u>

requires us to reconsider the conditions under which such a switch in the monetary system will succeed. “

Ecuador continued

- However, dollarization helped to strengthen the financial system.

"……dollarization in its early stages has **turned out more successfully than almost anyone expected.** " – see Stanley Fisher (2000).

El Salvador

- El Salvador, without any pressure of a crisis, introduced dollarization by fiat during a period of macro-economic stability.
  - above average growth
  - fiscal deficit was relatively low
  - successful maintenance of fixed exchange rate from 1993 to 2000.

El Salvador

- Public and external debts were manageable
- No turmoil in the banking system.
- Arguments for dollarization were based on the desire to tighten links to the US economy in order to spur foreign investment trade and economic growth. (Hinds 1999; Hinds 2002).

El Salvador

- The new dollarized regime was successful.
- Swiston (2011) examined El Salvador's transition to dollarization by comparing aspects of the regime to the fixed exchange rate regime prevailing before dollarization.
- He found that dollarization lowered interest rates 4 to 5% by reducing currency risk.
- Andrew Swiston is a former IMF desk economist for El Salvador.

Risks associated with dollarization appear to be lower than expected

- But for some Latin American dollarized economies an unanticipated cost recently has been higher risk on branches of banks originating in the issuing country (which happens to be the US) owing to contagion from the US financial crisis.
- This could be a one-time event, but there are obviously lessons to be learnt from this experience. See Jacome and Lonnberg (2010).

. How to Dollarize

3. **Appropriate Safeguards: Precautionary Borrowing .**

- An important step is to assess the ability of the monetary authorities to finance the transition to a dollarized environment, given that acquisition of millions of dollars' worth of bank notes from the issuing country is often indicated, in order to solve the practical problem of how to convert to the new notes.
- Formal arrangements with the issuing country to provide for transport of currency and replacement of used notes, and possibly seignorage sharing, is often possible.

Precautionary Borrowing

- **El Salvador** exercised the option of entering a SBA (stand-by borrowing arrangement) with the International Monetary Fund.
- Such arrangements are useful because they lend credibility to the new monetary arrangements with little up-front cost, provided that the conditionality and performance criteria is acceptable to the authorities. Since the economy was already fairly well-managed, relatively few reforms were required by the IMF.

Summary

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- Should the exchange rate be devalued for any reason, that credibility is lost, and an own currency becomes a considerable liability, creating uncertainty and distorting choices in government and private sector.
- In this circumstance, full dollarisation becomes the preferred option, removing the uncertainty about the value of domestic assets, and the associated incentive for capital flight.
- **Risks associated with dollarization appear to be lower than expected**